

Current Law & Economics Debates: Tools for Assessing Fundamental Cooperative Changes?

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Introduction

Farmer cooperatives appear to be facing two major challenges. The first is primarily economic – can farmer cooperatives operate and compete effectively in the contemporary global economy? The second is an “identity crisis” – what is a cooperative enterprise and what difference does the answer make? The two are integrally related. Bankruptcies of large and small cooperatives alike, financial difficulties of others, aborted attempts to create new cooperatives, creation of organizations with substantial non-cooperative characteristics, and changing perceptions about cooperatives have led to (1) court-mandated actions in bankruptcy, (2) litigation involving management, directors, employees and farmer members, (3) changes in the fundamental laws defining and authorizing cooperatives, and (4) confusion about the significance of cooperative fundamentals.

Motivation

Concerns about realistic cooperative roles in the future of agriculture and the integrity of the cooperative as a unique form of business interact with views that cooperatives have structural and operational limitations inhibiting their usefulness or even relevance. Observations that cooperatives are incapable of growth in today’s global economy, that “traditional” cooperatives are dinosaurs, or that cooperatives have fatal inherent weaknesses contrast starkly with evidence of dynamic cooperative development, formation of creative new cooperatives, and cooperative flexibility in the face of unfavorable economic conditions both in agriculture and other sectors of the world economy. The result is a serious debate about precisely what comprises the essential characteristics of a cooperative and what might be the consequences of deviation from those characteristics.

Thorough analysis of issues raised in the debate requires a combination of legal and economic analyses. The research reported in this paper integrates such analyses and applies the resulting tools to yield guidance in this critical debate.

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Objectives

This paper has four main objectives. The first is to recast general discussions of the issues into an operational framework amenable to analysis by legal/economic scholarship. The second objective is to determine the juncture of current legal and economic scholarship related to business firms that is most applicable to firms operating as cooperatives. The third objective is to apply the resulting analytical tools to identified cooperative issues to develop objective analytical tools for analysis. The final objective is to obtain useful information about selected issues that are fundamental to farmer cooperatives.

Preliminary Considerations

Search for a definitive list of characteristics that captures the “cooperative” nature of an organization is fraught with difficulties. The difficulties are not eliminated or even significantly reduced when objective economic analytical techniques are applied, although the search process itself is substantially enhanced.

For the most part, economic analysis takes as given the rules of conduct that establish relationships among actors in an economic system. The motivations of rational action with optimizing objectives can be traced through the range of permissible actions to determine (1) how the actors may be expected to behave and (2) the aggregate consequences of individual actor decisions. Conversely, analysis can accept as given certain defined objectives and assess objectively the optimal relationships that may lead to those objectives. Based on this analysis, “rules of the game” may be created in such a way as to allow the parties to meet their economic demands as efficiently and effectively as possible.

The “rules of the game” may be established in a number of ways. The full complement of rules that apply to any given situation where an economic choice is made involving one or more parties will likely be drawn from several sources. At one end of the scale lies privately negotiated and executed contracts that reflect the specific desires of the parties. Within certain limits (Baarda 2002) economic actors may establish the rules best suited to their individual goals. Rules may also be established by ownership of property and surrounding agreements on the property’s transfer and use. In a more formalized setting, economic actors may choose to realize their economic objectives by creating a firm that is itself an economic actor, the participating themselves in the firm as investors, managers, or otherwise.

Two sets of economic relationships are established when a firm is created. The firm is an economic actor with objectives, powers, and resources that abides by rules established for the firm as an entity. At the same time, each entity with an economic stake in the firm also adheres to the rules established for its participation in the firm whether as a partnership, limited partnership, corporation, limited liability company, joint venture or otherwise. It is these relationships that characterize the nature of the firm and upon which our inquiry into the nature of a cooperative is founded. The rules are discussed at length in the remainder of this paper.

Organizational Principles

The subject of our inquiry is the corporation. Corporate principles are sometimes listed as are cooperative principles, although not with the focus and attention devoted to cooperative principles.¹ While formulations differ widely, a list of seven characteristics describes most corporations. (Cox, p. 6).

1. Shareholders are not personally liable for the obligations of the corporation other than to the extent they can lose the value of the equity owned. The implications of limited liability in the financing context for cooperatives is noted below.
2. The corporate entity has perpetual existence that does not depend on changes in the makeup of its shareholders.
3. Corporations have centralized management implemented through the authority and actions of the board of directors.
4. Shares of stock or other interests in the corporation are generally freely transferable. This applies to publically held corporation but less so to close corporations. Close corporations restrict ownership and transferability for a number of reasons primarily through contractual agreements.²
5. The corporate business has access to debt and equity capital in a great variety of forms and in many markets. This capability to garner financing from many sources is one of the main advantages of the corporate business form and accounts for the growth of corporations, particularly in the latter part of the 19th century as business enterprise size and financial needs outstripped the capacity of individuals, families, or small consortia to provide adequate financial resources.
6. The corporate entity has most of the legal rights of an individual. It acts as a single unit to hold property, to contract, and to resort to the legal system to enforce its rights.
7. Many of the relationships among stakeholders are standardized by operation of corporate statutes giving stability and predictability to corporations, stakeholders,

¹ Corporate characteristics are important for a number of reasons such as Federal income taxation, limited liability, or financing purposes, among many others. This leads to specialized formulations that depend on the purpose for which principles are being used.

² Cooperatives may have some of the characteristics of close corporations such as limited transferability. Implications of this are being studied elsewhere.

and those dealing with corporations. This standardization includes institutional stockholder and creditor protections.

As in the case of cooperative principles, several formulations of corporate characteristics are offered as summary descriptions of the corporate entity. For example, a list of four (Solomon 1998) may include:

1. A corporation is a separate entity with perpetual existence. It exists apart from those who provide risk capital or who manage its business.
2. Liability for corporate debts is limited to the assets the corporation owns and does not extend to owners' assets.
3. The power to manage the corporation's business is centralized by delegation to the board of directors.
4. Stockholders can transfer their ownership interests to others without terminating the corporation's existence.

Given these few fundamental principles, an enormous variety of organizational characteristics can fit within the corporate fold. The importance of each principle is largely dependent on the circumstances that bring the principle into question.

Cooperative principles are an overlay on corporate principles, with some corporate principles being directly applicable but with others modified or eliminated by cooperative principles. Contemporary formulations of cooperative principles vary, but do not differ fundamentally from traditional principles. Combining summary statement of principles with the descriptive formulation of Agricultural Cooperative Service gives four principles for modern farmer cooperatives:

1. Cooperatives are owned and democratically controlled by those who use their services.
2. Net margins are distributed to users in proportion to their use of the cooperative.
3. Returns on investment are limited.
4. Cooperatives are financed substantially by those who use their services.

The first three principles are "traditional" and considered to be of prime importance by most writers as fundamental principles of a truly cooperative business enterprise. An organization operating according to the three principles will be cooperative in nature, but an organization deviating from one or more principles will not necessarily be a cooperative. The

three principles are common factors in statement of principles, whether the lists are condensed to only three (Nourse, Fetrow) or expanded to several. (Bakken and Schaars, Bakken, Schaars, Packel). The fourth principle is a restatement of the ownership feature of the first principle. It is stated separately because of current interest in member-financing techniques, particularly the equity redemption process unique to cooperative enterprises financed on an as-needed basis by owner-users.³

The most definitive set of principles has been developed by USDA. (Dunn). Modern principles are:

1. The User-Owner Principle: The people who own and finance the cooperative are those who use the cooperative.
2. The User-Control Principle: The people who control the cooperative are those who use the cooperative.
3. The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

A summary definition of a cooperative enterprise incorporates all essential principles. As defined in the 1967 USDA publication *Cooperative Criteria* (Savage and Volkin):

A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative.

The current challenge to cooperative definition involves two issues. First is the question whether the stated principles are relevant. The second is to what extent a firm (a) must adopt all principles completely to be considered a cooperative or (b) may modify some principles while maintaining others. The challenge may be placed in perspective by recognizing that all important characteristics of cooperative and non-cooperative corporations can be placed on a continuum. At one end of the scale are simple, clearly “cooperative” characteristics. At the other end are characteristics that push the envelope of “accepted” cooperative ideals. Beyond that point the firm must be considered a non-cooperative corporation.

³ Examples include General Accounting Office, Cobia, Hamilton, Baarda (1989), among many others.

Table 1 summarizes the continuum conceptualization of the cooperative firm. It is evident that no single continuum exists. Rather, a significant number of relationships each exhibit a separate continuum. In the remainder of this paper the cooperative – non-cooperative theme is developed using sets of rights and obligations considered in the context of corporate legal theory.

Table 1. Continuum of Interests From Cooperative Corporation to Non-Cooperative Corporation

	Cooperative		Non-Cooperative	
1. Goals	<i>Market Power</i>	<i>Handling, Efficiency</i>	<i>Value-Added to Commodity</i>	<i>Value to Equity-Holders</i>
2. Commodity Focus	<i>Commodity only</i>	<i>Commodity Positioning</i>	<i>Transformed Commodity</i>	<i>No Commodity</i>
3. Member Relationship	<i>Behavior contract</i>	<i>Marketing and Business</i>	<i>Entity Focus with patronage relationship</i>	<i>Entity Only</i>
4. Capital Relationship	<i>Minimal</i>	<i>Contract and Operations</i>	<i>Shared Capital Focus</i>	<i>Capital Focus</i>
5. Benefit Allocation	<i>Commodity Prices</i>	<i>Commodity Prices, Returns and Savings</i>	<i>Enterprise Returns, Commodity Basis</i>	<i>Enterprise Returns to shareholders</i>
6. Risks	<i>Price and Market</i>	<i>Price, Market, Operations</i>	<i>Price, Market, Operations, Equity</i>	<i>Equity</i>
7. Control	<i>Contract</i>	<i>Contract, Entity Ownership</i>	<i>Contract, Entity Ownership</i>	<i>Equity Ownership</i>
8. Strategy Focus	<i>Pricing</i>	<i>Pricing, Commodity Positioning</i>	<i>Value Added, Market Response, Pricing</i>	<i>Profit Maximization, Market Response</i>
9. Entity Functions	<i>Bargaining Obligations</i>	<i>Pricing Obligations, Capital Use, Operations</i>	<i>Pricing Obligations, Capital Use, Operations</i>	<i>Returns to Capital, Operations</i>

Broad Themes in Legal and Economic Firm Theory Development

Three broad themes help define the landscape of corporate theory. These same themes provide the major contact points between the law of corporations and the economics of the firm. Their central position in corporate theory suggests that they may provide major points of departure in addressing cooperative – non-cooperative corporate theory, the subject of this paper.⁴

Corporation As Person

The fundamentals of corporations, including cooperatives, begin with the concept that the corporation is an entity with the legal status of a “person” for most purposes. As such, the corporation holds property, enters into contracts, engages in business transactions, and generally acts in all regards on its own behalf. Stockholders are separate from the corporation, as the corporation is separate from the stockholders. A corporation is liable for its own obligations, not those of its stockholders, and *vice versa*.

The classic definition of a corporation was given by Chief Justice John Marshall in 1819.⁵

A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal being.

This definition, though classic, cannot convey the full range of corporate fundamentals and character, although its focus on the “person” concept undergirds many characteristics

⁴ The substantial body of work on cooperative theory is not included in this paper. Such work addresses many important issues that can usefully be included in the kinds of discussion recommended in this paper.

⁵ *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819)

possessed by corporations.⁶ From this concept, or perhaps in reciprocal relationship with it, are the recognized corporate characteristics that include centralized governance, shareholder interest, limited liability principles, and other principles discussed subsequently.

Separation of Ownership and Control

Observers of corporations and corporate growth in the United States long ago identified a characteristic change in ownership and control with the growth in size and complexity of corporations. This phenomenon was the separation of ownership and control in publically held corporations.⁷ The general idea was that the enormous collection of capital identified with corporations made possible by division of ownership into shares of stock does not carry with it effective participation in the control and management of the corporation. According to that view, the board of directors and management, particularly management, can therefore develop their own agenda for the corporate entity that is not necessarily in the best interests of the stockholders.

Investigation into the theory of the firm began to diverge from the simple transactions cost format during the decade of the 1970s.⁸ Attention began turning toward the issue raised by Berle and Means – the separation of ownership and control – with the important difference that, unlike Berle and Means, the task became one of understanding how firms organize to resolve the problem. Commentators began to raise issues such as a moral hazard analysis, shirking, and opportunism that are not easy to explain using only transactions cost considerations.⁹ Increasing attention was given to the problem of achieving incentive alignment of participants within the firm. (Demsetz).

Ownership and control issues have directly and indirectly raised a number of issues in law and economics that have been developed into firm theories. The most well-known is the principal-agent model of the corporation in both law (Easterbrook and Fischel, Brudney) and economics. (Fama, Fama and Jensen, Jensen and Meckling). Generally, the principal-agent model has led to two themes in the literature. One theme is that the central issue in corporate law and economics is to reduce agency costs by devising methods to keep those controlling the

⁶ The legal entity concept is central to the corporate character but its precise significance is challenged by several lines of legal theoretical inquiry.

⁷ Berle and Means. Publically held corporations issue equity interests not necessarily restricted to either number or identity of stockholders. In common parlance publically held corporations are often equated with corporations whose security is subject to regulation under the Securities Act of 1933 or the Securities Exchange Act of 1934.

⁸ Demsetz. “Transaction cost” considerations provided another early perspective on corporation theory. The classic introduction of the transactions cost view of corporations was presented in Coase (1937). The article is reproduced with other important Coase material in Coase (1988).

⁹ The literature is extensive and references are not included in this paper.

corporation true to the task of managing the firm for the benefit of the owners – the stockholders. A second theme is that the primary goal of the public corporation should be to maximize shareholders' wealth. That principle leads to the question of relative positions of firm owners and resource owners. (Greenwood).

Another implication of the separation of ownership and control, also related to the problem of contracts and the uncertainty of nonperformance, is the problem of appropriation from owners. When an asset is owned by one entity and rented to another, the owner wishes to obtain quasi rent, that is, the value of the next best use to another renter. (Klein Crawford Alchian). If conditions in the market are such, however, that no alternative exists, the renter can appropriate the owner's quasi rent because the owner's alternatives are nil. Restricted use assets are particularly subject to this behavior. If the quasi rent on one asset is closely tied to some other particular asset, both assets will tend to be owned by the same party. Opportunistic behavior by renters presents a similar problem.

The separation of ownership and control concept has led to a substantial debate in corporate law and economics beyond its role in informing corporate analysis. The debate pits "managerialism" against "shareholder primacy."¹⁰ The managerialism position views the corporate entity as essentially a bureaucratic hierarchy that is dominated by a cadre of professional managers. Shareholders have little real input into the essential decisions of a corporation given the roles assigned by corporate law to the board of directors and the business judgment rule that gives the board considerable leeway to make decisions about the corporation. The shareholder primacy theory at one time was based on the theory that shareholders own the corporation with directors and management acting only as stewards of the shareholders' interests. Bainbridge argues that the shareholder primacy argument is now cast in terms of the nexus-of-contracts theory (discussed below) and that the fact of ownership is largely irrelevant to the shareholder primacy theory. Shareholders retain a favored position in the contractual scheme, but property ownership is not the defining relationship in modern corporate theory.

The Firm As Transaction Set

Private ownership of factors of production means that each input owner can produce and market goods, sell the input outright, or enter into contractual arrangements and surrender the use of the input to an agent in exchange for an income. (Cheung 1983). Creation and use of a firm is another option to this choice set. The entrepreneur or agent with a limited set of rights can, by contract, direct production without a direct reference to the price of each activity as if it was a market. The reason that a private factor owner would surrender the rights over the allocation and use of the factors of products is, under transactions cost theory, to reduce transactions costs.

Commons introduced a view of the firm focused on transactions in 1934, thus stepping aside from a purely formalistic structural view. (Commons). A new window into the firm was

¹⁰ See Bainbridge for a summary of the arguments and his conceptual response.

opened. Soon thereafter, Coase (1937) published his seminal article on the nature of the firm that has led to a long history of discussion and productive analysis based on transactions cost. Two themes of inquiry have flowed from transactions-transactions cost views of the firm.

The first is the characterization of a transaction as being either internal to the firm or an external transaction. If all transactions surrounding an economically productive activity are considered together, they may be divided into intra-firm transactions and enter-entity transactions between the firm and another economic entity. Applying Coase's summarization that "the distinguishing mark of the firm is the supersession of the price mechanism, we can define the firm's boundary as the point at which the price mechanism of the market is replaced by authoritarian, power-based decision-making within the firm. (Coase 1937). Williamson (1975) further refined the transaction concept and proposed that the main distinction between transactions within the firm and those outside the firm is based on the driving force of the decisions made in the transaction. For transactions among firms defined to be outside the firm, the market determines every element of supply, demand, and pricing. On the other hand, decisions regarding all aspects of an intra-firm transaction depend on the internal power and control hierarchy of the firm. Other observers have described the distinction using other criteria, for example the nature of the product subject to the transaction. Market transactions are said to involve products or commodities while intra-firm transactions involve factors of production. (Cheung 1983).

The task of deciding how to assign a transaction its place as intra-firm or inter-firm is difficult given the limitless alternative of business arrangements possible for any transaction. However, such an exercise is necessary to determine the boundaries of the firm. Further, an answer is necessary to even determine if a firm exists. Coase himself observed that "it is not possible to draw a hard and fast line which determines whether there is a firm or not." (Coase 1988, p. 40, n.21). He introduced the fundamental "tautology" that transactions will be internalized in the firm so long as the transactions costs of the internal transactions do not exceed the transactions costs of those same transactions when they take place in the market rather than within the firm.

Identifying and measuring such costs is another matter. Information costs and agency problem costs are two favorites of academic discussion. Both, and all other sources of transaction costs, suffer from the difficulty of objective measurement and of comparison problems. Transactions costs are almost always of a distinctly different character for transactions of exactly the same kind depending on whether the transaction is intra-firm or inter-firm. (Demsetz). "[I]t is difficult to use the magnitude of 'transaction' cost relative to 'management' costs to predict how changed circumstances affect economic organization." (Demsetz, p. 149). Demsetz also notes that measurements are organizational dependent. "The confusion that exists in the literature derives from a hidden presumption that we are still guided by the perfect decentralized model, and that, in some respects, information remains full and free." (Demsetz, p. 148).

Selected Legal Theories of the Corporation

Legal literature of the past two decades has been active, creative, and dynamic in addressing the very conceptual foundations of corporate law. Some influence has been drawn from the three preceding observations – corporation as person, separation of ownership and control, and transactions nature of the firm. Other influence has been more directly related to corporate legal structure, public policy, and efforts to keep up with the rapidly changing business world. Distinctly different and sharply conflicting theories have been proposed to describe “what goes on,” make predictions about the future, and advocate policy changes toward corporations.

Not all legal theories of the corporation can usefully be formulated in terms of pairwise debates although certainly some schools of thought lend themselves to such contrast. For purposes of this paper, however, selected theories will be described as free-standing arguments first, then appropriate and selected comparisons with other theories will be noted. The objective here is not to describe either all of the main theories or to delve into the implications of each theory, some of which are rich in implication. Implications will not be explored in the summary of theories but will be left to specific application to cooperatives in the following sections.

Corporation as a “Nexus-of-Contracts” – and Variations

The proposition that a corporation is a legal fiction is carried further to hold that a corporation in reality is a “nexus-of-contracts.” Corporations “are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.” (Jensen and Meckling). All of the relationships among all of the individuals related to a corporation could be and are viewed as simply a rather elaborate set of contracts establishing the rights and obligations of all parties associated with the fictional corporation. The question whether these are actual contracts or relationships established as if they are contracts is a major source of contention and challenge.

The nexus-of-contracts theory has gathered a substantial following and is influential in many important discussions about the corporate form of business. The more committed proponents of the nexus-of-contracts theory, the true “contractarians” in academic parlance, propose that the contracts making up the nexus are simply contracts, nothing more and nothing less. As such, they are voluntary agreements among individuals. Some believe that this view of the relationship among individuals obviates the necessity, importance, or even the possibility of distinguishing between contracts representing transactions within the firm and those outside the firm. (Jensen and Meckling, Alchian and Demsetz, Cheung (1983), Klein, Hart (1989), and Schwab). Coase’s distinction is not critical because whether a firm or corporation exists is not important.

Others adhering to the nexus-of-contracts view of corporations believe that the intra-, inter-firm distinction is important regardless of the view of the corporate entity. (Spence). Contracts may still be defined as intra- or inter-firm transactions. (Easterbrook and Fischel). As

with the distinction for transactions, and in addition to such considerations, contractual characteristics have been suggested as distinguish between internal agreements and cross-boundary agreements. The market-driven versus corporate hierarchy distinction is one such approach. Others note the degree of specialization of a contract or the length of time of association among the parties as a guide. Within the corporation, the decision process is comprised of steps such as initiation of proposals for resource use, ratification of the choice of decisions, executing the decisions, and monitoring performance and allocating rewards. (Fama and Jensen). The degree of conscious direction that is used to guide the uses to which resources are applied relates to the identity of the firm and the contracting nexus. (Demsetz). A contractual paradigm for the corporation implies further that the general rules of contracts will be applied to establish and allocate rights and obligations within the firm, including supplementation with contract law principles. (Cheung 1983, Baarda 2002).

Of the many implications of the contractarians' position, two are of most direct interest for purposes of this paper. The nature of property ownership systems will be established by the contract system. When a resource's owner, including the owners of labor, become part of the firm, the owner is not required to sell the resources. Rather, the owners retain some rights and the contract becomes a "structured document" between the owner and the other party. (Cheung 1970). The key to the successful nexus is that the owner agrees to coordinate actions by participating in the system and not simply take an independent course of action regarding the property based on market forces. (Cheung 1983).

Another function of the contracting system in a nexus adds certainty to transactions and the relationship making the nexus. The value of the contract collection depends on the certainty brought to the firm and to all stakeholders. The certainty objective may also help determine whether the contract is intra-firm or inter-firm. If uncertainty can be brought within the firm, costs of enforcement may be reduced, an allocation of decision management, decision control, and residual risk allocation. (Fama and Jensen). The role of shirking, cheating, and opportunistic behavior may suggest that the contract should be brought within the firm. (Williamson 1975, Klein Crawford and Alchian, Demsetz).

Recent commentary has refined and modified the generally understood nexus-of-contracts approach to corporate structure to identify the nexus within the corporation itself. In one modification, Bainbridge identifies the board of directors as the nexus of contracts, a concept of considerable interest to cooperatives. This flows from his argument, summarized above, that shareholder primacy is found not through the position of shareholders as owners but through the board of directors as the nexus of contracts relating all interests together, including the special interests of the shareholders. A second modification of the nexus-of-contracts argues that a corporation is not even a nexus of contracts. (Gulati Klein and Zolt). Rather, a "connected contracts" model denies that a firm has any boundaries and the because almost everything that makes up a firm is contracted, the contracts run directly among all the parties rather than through the mechanism of a firm. Bainbridge criticizes this position as being too extreme.

Anti-contractarians – and Variations

In reality, of course, corporations do indeed follow rules that are not imposed by private, individual contract but rather by the relevant incorporation statutes. This seeming conflict has led to substantial debate on the relative roles of contracts (implicit or explicit) and corporate statutory law. (Clark, Eisenberg, McChesney, Bebchuk, Coffee). One focus of the debates is the freedom to make contractual arrangements independent of and perhaps in contravention of mandates of incorporation statutes. The contractarians' view incorporation statutes as not that significant in the theory of the firm. The argument is that the essence of the corporation is determined by the private contracts that can, with complete freedom to contract found in contract laws, modify the relationships otherwise assigned by incorporation law.

Commentators not fully accepting the contractarian views point out that not all requirements and restrictions of the incorporation statutes can be freely modified or abrogated by merely re-contracting on the issue. (Bebchuk, Eisenberg, McChesney). This limits the role of contracting to the point that the nexus-of-contracts view of corporations cannot be fully accepted.

Another line of argument has challenged the assumption that a nexus-of-contracts approach is an economically useful construct. One set of costs internal to a firm is that of agency costs. (Jensen and Meckling). The contracts in a nexus-of-contracts formulation of corporate legal structure are not costless because of structuring, monitoring, and bonding costs issues. Agency costs must also include the value lost from the costs of enforcing contracts. (Jensen and Meckling). Thus, the presence of incorporation statutes that stand apart from a contracting system eliminates some of the costs. Following the Coase-Williamson approach, such costs may mean that the statutory structure is superior to a contracting structure. It may also mean that the mix of corporate incorporation statutory law and voluntary contractual rules will vary from organization to organization.

Critics of the nexus-of-contracts construct point out that contracts do not establish the kind of relationships inherent in corporations. The prime example is that of fiduciary relationship. Parties to a contract do not have fiduciary (obligation of the highest level) relationships with other contracting parties. This level of trust is not assigned in contracts. However, identified stakeholders in a corporation do in fact stand in a fiduciary relationship with others. The board of directors and shareholders relationship is one example. Thus, a corporate structure based solely on contracts as in the pure nexus-of-contracts view of corporations missing an essential element of the corporate entity.

A solution that combines the voluntary organization characteristics of contractual arrangements with a fiduciary relationship is based on a trust arrangement. In this conceptualization, the corpus of the trust – the corporation's assets – are held in trust by management for the owners as beneficiaries. (Kornhauser). The appeal of the trust theory of the firm is that the fiduciary duties of loyalty and care imposed on corporate directors and officers can be explained by the fiduciary duty of a trust's trustee. At the same time, complete freedom to

contract as the sole structure of the corporation could defeat the fiduciary relationship. This means that supporters of the trust theory insist that certain obligations and duties inherent in corporate law cannot be contracted away. A set of mandatory corporate rules remains for corporate firms. (Kornhauser).

Corporate Economic Environs

To this point, the basic corporate structure has been defined in terms of principles related mostly to the precepts of the corporate legal structure. The transactions cost discussion alluded to transactions and contract placement, whether within or outside the firm. This section on corporate economic environmental considerations takes one step further to briefly mention the relationship between a firm's external economic environment and the impact on the internal organization of the firm. This view of the firm recognizes that the organizational structure of the firm depends on the market structure environs of the firm. (Caves). This theory also addresses the issue of firm boundaries.

Caves, treating the question as a normative and efficiency issue, asks the question "has the boundary between administration and the market" been optimally located? The "organizational production function" determines the relationship of internal control and control mechanisms to the optimal flow of information within the firm and the multiplication of hierarchical levels as they relate to the firm's efficient overall size. Functional and divisional internal organizations yield advantages and disadvantages under differing circumstances. (Chandler, Caves). In broader terms, theories may relate the overall form of the business enterprise to economic efficiency generally. (Cotterill).

A second aspect of the economic environs is that of relating the economic system outside the firm's boundaries with that inside the firm, blurring the boundaries. While certain transactions may be brought within the firm's boundaries to isolate them from the market, market principles may also be brought within the firm to meet desirable goals. The transactions previously outside the firm were governed by market conditions. These transactions, now internal to the firm, must be measured in some fashion to determine many of the same characteristics that the market would impose, such as adequate performance, costs controls, efficiencies, response to needs, etc.

Once absorbed into the firm and applied to internal transactions, an internal system for imposing discipline based on the market may be achieved by transfer pricing. However, some of the problems with the market that the firm sought to solve by internalizing the transaction follow the process. Organizational structure influences this internal pricing mechanism where incomplete contracts exist, for example, and when new agreements must be negotiated periodically. (Grossman and Hart, Holstrom and Tirole). Though the process is entirely within the boundaries of the firm, the effect may be to impose market discipline even on internal transactions. (Holstrom and Tirole).

An alternative view of internal corporate structure seeks to avoid principal-agent issues internal to the firm has recently been suggested by Blair and Stout. Their “team production” view of the corporate firm posits that all participants in a production process are team members. The team members are required to give up substantial rights, including property rights over the team’s joint output and team inputs such as financial capital and firm-specific human capital. The rights are surrendered to a legal entity created by the act of incorporation. The board of directors is in complete control of the use of the assets and allocation of results of production. The corporation is, importantly, a “mediating hierarchy” that mediates disputes among team members about allocations of the results of production. Blair and Stout propose the team production theory as an alternative to the principal-agent analysis that focuses on the difficulties of drafting explicit contracts to keep agents faithful and the property rights analysis that proposes that contracting problems may be overcome by giving ultimate control rights to one party to the contract through ownership.

A Hint of Institutionalism

Legal scholarship is generally steeped in history, from the rule of precedence in which prior legal formulations provide the rule in current disputes until positively changed, to inquiries into the historical and social rationale for current jurisprudence. Somewhat more interest is shown in the social and economic basis for the corporation in historical context. From an economic perspective, formulations of behavior-based views of the firm provides a point of analysis of cooperatives.¹¹

In his review of Chandler’s 1990 overview of business enterprise growth and development, Teece notes that Chandler’s work is shaped by the commanding thesis that the business and its managers are not merely reacting to broader technological and market forces when they are created and structured. Chandler points out what should be the obvious, that firms are shaping the market and its outcomes. They are not simply agents of the market, markets are agents of the firm. This theme follows the emphasis of institutional economics that places weight on factors of human behavior, particularly habit, and avoids characterizing all human economic behavior as nothing more than rational calculation (Hodgson), a concept at odds with the rationale of the great proportion of the corporate law and economics discourse.

A related concept, drawn more from economics, that related to cooperatives is the view that the process by which a firm is created and designed may in itself affect the form of business ultimately created. (Williamson 1988). Although economic and legal analysis may dictate that a firm of a specific kind will exist in a defined set of environs, the process by which the firm arrives at its final manifestation may yield a firm that does not meet the objective specifications. While the proposition that process matters is not widely discussed in the legal literature nor the law and economics literature, Williamson (1988) and others believe it to be significant.

¹¹ “Neo-Institutionalism” is not addressed here although cooperative scholars have applied such ideas to cooperatives. (Royer, Sykuta and Chaddad, Iliopoulos and Cook).

Communitarianism, Progressivism, and Beyond

Not all legal scholars, business observers, or public policy-makers have accepted the inward focus of firm and corporate theory without reservation. Reactions to the principles described above, based largely as they are on neoclassical economic principles, have led to proposals for modifications of the legal structure, mandates, and control mechanisms typically described for corporate firms, primarily in legal scholarship. In general, commentators in the “communitarian” or “progressive” school of corporate thought advocate the position that corporate directors, as representatives of control, should be required to serve not only narrow shareholder wealth maximization goals but also those of other stakeholders such as employees, the corporation’s customers, creditors, and perhaps others. (Coffee, Greenwood, O’Connor (1993), and Spoerl). Some of these normative views have found their way into corporate statutory mandates commonly called “constituency statutes” that require corporations to consider the interests of non-shareholder stakeholders when certain major decisions are made that will change the character of the corporation through merger or sale. The overall position of the progressivism is, however, considerably broader than itemized recognition of “outside” interest in limited circumstances.

The foundation of progressive corporate legal scholarship is that the corporation plays too pervasive a role in every life to justify its focus on serving the sole interests of its internal stakeholders by private agreement. The view is summarized by Mitchell:

Our historical treatment of the corporation as a public good in the private service can no longer be sustained. Whatever might have been true in the earlier days of industrialization now is clearly mythology. It is time that the corporation be recognized for what it is: a public institution with public obligations. As we turn to a new century, the second century of corporate law, it is necessary to begin to evaluate the extent to which the corporate invention must be adapted to the tasks it now in fact performs.¹²

Communitarian or progressive positions are sometimes described as flowing from three criticisms of positions commonly assumed in contractarian positions. (Millon). Communitarians define both the collection of those affected and the types of impact more broadly than contractarians adhering to neoclassical economic analysis. This leads to a challenge of the key assumption that non-shareholders can protect themselves through bargaining, market participation, and voluntary contractual mechanisms. Even if a mechanism existed for the representation of all properly considered interests, the bargaining position of participants would make self-protection impossible for all practical purposes. The third objection to the purely voluntary, wealth maximization justification for the current state of corporate law rests on communitarians’ broader vision of corporate relationships. Communitarians’ “perspective grounds obligation on a rich foundation of mutual trust and interdependence rather than limiting

¹² Mitchell, Preface, p. *xiii*.

it to the bare bones of actual contractual terms and rests on a vision of the corporation as a community rather than a mere aggregation of self-seeking individuals whose relationships are defined solely by contract.” (Millon, at p. 4.)

In response, some communitarians suggest changes in fundamental ways of thinking about the corporate structure. Some commentators seek to replace the shareholder-centeredness of current law and economics views of the corporation with various kinds of coalition theory. (Dallas). Some communitarian scholars hold that the contractarian formulation of corporate legal theory can simply be modified to either recognize the need for structure and authority in corporate fiduciary principles. (Branson). Others, however, would propose significant modifications to the current neoclassical, law and economic view of corporations to recognize a wider range of interests and perceptions. (Bratton, O’Connor (1995), Solomon).

A “Rights and Obligations” Framework for Organizational Analysis

Separating out considerations that are essentially behavioral within a defined framework such as that of a firm leaves us with an organization defined by the rights and obligations attending to the organization and regulating or otherwise defining all interests that make up the firm. Externally, the firm becomes an entity defined by the rights and obligations that make it an entity as noted above in the fundamental definition of a corporation. It is a corporate body. To provide focus for this paper and in keeping with the almost universal organizational structure of cooperatives, this can be limited to a corporate body.

Choice of Legal Framework

Three sets of legal subject matter lend themselves to a mechanism for analysis appropriate for this paper – property rights, contract and related obligation, and corporate law.

Property rights analysis has been developed as a method to analyze organizational structures (Grossman and Hart) and has been productively applied to cooperatives. (Royer, Sykuta and Chaddad, Iliopoulos and Cook, Cook and Iliopoulos, Fulton, and Chaddad and Cook). While property rights may be useful for certain kinds of analysis, property law does not lend itself well to a complete description of the rights and obligations sets within a corporate firm. A wide range of relationships, including those of most interest in investigating internal corporate and cooperative relationship among various stakeholders within and outside the firm are not based on property or rights in property. To artificially appeal to property rights when the rights and obligations are actually established without regard to property law is not particularly helpful for purposes of this paper. Indeed, identifying ill-defined property rights as the problem with an organizational structure may in fact be an indication that the application of property rights analysis to the system is inappropriate. In this paper, therefore, property rights are not used.

The remaining two legal subjects – contracts and corporate law – may seem to be distinct. However, as noted above, contract and the firm are inseparable in discourse. Assuming that the contractarians have failed to completely conquer the field and define every possible character of a firm in terms of contract, and that the various anticontractarians have failed to eliminate any element of voluntary contractual arrangement from the corporate law paradigm, we are left with both. In the following application of legal theories of the firm to cooperatives, the distinction is noted but is not made a defining point, leaving the useful and realistic flexibility of both when describing the complex relationships that make up cooperative and non-cooperative corporations.

Internally, the corporate firm is defined by a more complicated set of rights and obligations that involve both the firm itself and all other entities that have a relationship close enough to the firm to be loosely termed “stakeholders” suitably defined. Analysis of these rights and obligations permits us to determine all essential characteristics of the organization including how the corporation addresses fundamental agency problems, transactions cost issues, ownership, and control problems as well as optimization and allocation of returns. The set of rights and obligations defining the corporation and each of its stakeholders provides the foundation upon which economic decisions are made and stakeholder objectives are realized. Most importantly for purposes of this paper, the full complement of rights and obligations among all relevant entities defines the cooperative character of a corporate entity.

The rights and obligations analysis may be made operational by focusing on selected, identified characteristics of the set of all rights and obligations that establish a firm. Following is an eight-fold categorization with brief notation of each item’s importance and implications for cooperative corporate definition. Special note is made of the cooperative - non-cooperative distinctions where appropriate.

Identifying Stakeholders

The first logical step in an analysis of rights and obligations sets is to identify those who qualify as stakeholders in the firm. The segregation of those who are stakeholders and those who are not considered stakeholders depends, of course, on the criteria by which to judge the relationship. This is a two-fold process. First, some criteria must be established that define a “stakeholding” relationship. That is, what set of rights and obligations will establish the closeness of the parties sufficient for us to call them stakeholders? Second, the rights and responsibilities that define any particular relationship and the totality of multiple relationships must then be determined and applied to see if they fit the stakeholder requirement.

Two examples drawn from cooperatives demonstrate that stakeholder identification is a factor in assessing the cooperative and that changes in the cooperative may result in changes in stakeholder identification. The customers of a corporation are not considered stakeholders under most circumstances. While customers have an “interest” in the corporation’s welfare and its behavior, neither the corporation nor the customers have the kinds of rights and obligations with respect to the other to make them stakeholders. Such is not the case for a cooperative.

Cooperative patrons are an integral part of the cooperative and the shared rights and obligations running between cooperative and patron establishes patrons as stakeholders.

The second example shows that the exclusion of a party as a stakeholder is important for cooperative considerations. So long as all equity is supplied by patron-members – those who own the cooperative, control it, and benefit from it – no investor outside the patronage relationship is a stakeholder. However, with equity investment from parties who are not patrons a new set of stakeholders is absorbed into the cooperative corporation. Because these entities are stakeholders, the set of rights and obligations running between the cooperative and the investors become an essential part of the cooperative's character. If the institutional and historical definition of a cooperative seeks to reserve the set of stakeholders to those who have a patronage relationship with the cooperative, then the non-patron investors would be unwelcome as stakeholders.

We would expect communitarian-progressive proponents to expand the definition of stakeholder beyond those traditionally associated with either a cooperative or non-cooperative corporation. This expansion is essentially almost the entire thrust of the communitarian-progressive position. However, expanding the identity of stakeholders as proposed by this view of corporations affects cooperatives and non-cooperative corporations generally alike. For cooperatives, for example, avoiding mere investing entities as stakeholders would not be changed by a communitarian approach.

A corporate economic environs approach suggests that the identity of stakeholders is determined by the needs and wishes of those creating and defining the organization. If the actors are producers who wish to share benefits of collective action, patrons would be expected to take a role as stakeholders. At the same time, if those with authority to decide on the character of the rights and obligations that will define the firm believe that non-patronage equity contribution is a requirement for the objectives they wish to achieve through the vehicle of the corporate entity, those equity contributors may be made stakeholders.

The nexus-of-contracts perspective would not seem to place any limitations on stakeholder identity. Whatever the various parties want to do and whatever set of contractual arrangements (rights and obligations sets) the parties want would be entirely satisfactory. Those who did not wish to participate would not be required to. Those who do not accept the complete freedom to act proposed by the contractarians would most likely resort to the statutory foundations of the corporate entity to determine who is a stakeholder. The distinction between cooperative and non-cooperative corporation would be founded in the statutory description of a cooperative as compared to that for a corporation.

Stakeholders' Relationships to the Corporation

The most direct and obvious set of relationships in a firm that is defined by rights and obligations between the corporation and the identified stakeholders. One characteristic of such

relationships is the binding nature of the rights and obligations established. The second, related, of course, is the type of transaction or relationship actually covered by a set of rights and obligations. Cooperative — non-cooperative corporate differences are found in both the type of transaction subject to a rights and obligations relationship and in the substantive content of such relationships. In addition, the additional stakeholder sets in a cooperatives will lead to a more extensive set of relationships in a cooperative than a non-cooperative corporate firm. A third distinguishing general characteristic of cooperatives is that each relationship between stakeholder and the corporation depends on the capacity in which the stakeholder stands to the cooperative, and each stakeholder will likely stand in multiple relationships such as patron, owner, voter, residual claimant, etc.

The essential complement of relationships between stakeholder and cooperative corporate entity is summarized in cooperative principles in the form in which they are made operational in specific sets of rights and obligations. Stakeholders in their control capacity have a right to vote according to methods and powers agreed upon and the cooperative is obligated to establish a control mechanism in response. Stakeholders in their capacity as owners are bound by equity contribution rules in the cooperative and the cooperative likewise has rights to capitalization and a set of obligations to the owners. Stakeholders who are recipients of the benefits offered by the cooperative have a set of rights and obligations based on patronage, patronage refunds, and other possible mechanisms devised to implement the user-benefit principle. The cooperative firm has reciprocal rights and obligations regarding the ownership relationship.

Accepting wholesale the position of the most dedicated contractarians that a firm really does not exist would require something of a stretch in perception when viewing critical rights and obligations as those running between stakeholder and the cooperative firm. Rights and obligations sets running between firm and stakeholder seem more amenable to the corporation-as-person paradigm that is the essence of statutory corporate law noted previously. Mandates of the rights and obligations sets establishing the cooperative relationships within a the firm are much more extensive in the cooperative than an non-cooperative corporation. As a result, the corporate formulation for a cooperative corporation is more dependent on statutory structure.

This is not to say that the nexus-of-contracts theory of corporate law is not applicable. While the systems of implicit contracts are more complex, the contractual approach has the advantage of giving better breakdowns of the combination of rights and obligations inherent in a cooperative firm. They are descriptive of each set of rights and obligations in the context of each stakeholder capacity applicable. The central role of principles could fold almost all analysis into a single consideration of the rights and obligations that make a firm a cooperative. Following sections of the paper separate out subject matter into more precisely defined issues for clarity.

A larger overview of the cooperative corporation invites observations on the economic environs and institutional corporate legal theories. It is clear that an extended complement of stakeholders with multiple purposes stand in multiple relationships with the cooperative and that an exceptionally large collection of rights and obligations run between firm and stakeholder. The

question of why the particular set of relationships creating a cooperative is established depends on motivations outside the cooperative. For the most part, choices are market driven, from the overall objective of a cooperative to gain some advantage in the market for its patrons or correct market failure, to various efficiency, market power, or value-added goals. The view that the structure of the firm is determined by needs and objectives fits the cooperative business form well. An institutional approach may further enhance an appreciation for the rights and obligations complement thought to be cooperative in form, including the traditions of cooperation in agriculture and the definitions of cooperative principles themselves.

Stakeholders' Relationships to Each Other

After the peculiar substantive relationships established between a cooperative firm and its stakeholders noted above, perhaps nothing defines a cooperative, as opposed to a non-cooperative corporation, as much as the interrelatedness of interests within the cooperative. This network of rights and obligations is the hallmark of cooperation within a firm. The interdependence of stakeholders is shown in one example applicable to delivery contracts. A common statutory provision enhances a cooperative's authority to specify damages based on the principle that damages may exceed those of a single breach because all patrons are damaged. Bylaw examples enforce this by provisions such as the following:

The remedy at law would be inadequate and it would be impracticable and difficult to determine the actual damages to the Association should Producer fail to deliver the _____ (product) covered by this agreement. Therefore, regardless of the cause of such failure, Producer agrees to pay to the Association for all such _____ (product) delivered or disposed of by Producer, other than in accordance with the terms of this agreement, a sum equal to _____ % of the fair market value of the product at the close of business on the day the product should have been delivered to the Association, as liquidated damages for the breach of this agreement.

All parties agree that this agreement is one of a series dependent for its true value on the adherence of all the contracting parties to all of the agreements, but the cancellation of any other similar agreement or the failure of any of the parties thereto to comply therewith shall not affect the validity of this agreement.

Statutory recognition of the economic relatedness of patron interests is found in a typical provision as follows:

(a) The by-laws or the marketing contract may fix, as liquidated damages, specific sums to be paid by the member or stockholder to the association upon the breach by him of any provision of the marketing contract regarding the sale or delivery or withholding of products; and may further provide that the member will pay all costs, premiums for bonds, expenses and fees, in case any action is brought upon the contract by the association; and any such provision shall be valid and enforceable in the courts of this State; and such clauses providing for liquidated damages shall be enforceable as such and shall not be regarded as penalties.

This is only one example of the multiple interrelationships with a cooperative corporate firm. Further exploration of other sets of rights and obligations among all stakeholders in a

cooperative will include the broader stakeholder set and the multiple capacity in which each stakeholder group is bound to the cooperative. Conclusions may indicate that a new look at some fundamental corporate assumptions is required.

As has been noted, separation of ownership and control underpins a substantial proportion of all legal-economic corporate theory. Principle-agent and offshoot theories rely on the ability of management to express independent behavior in contravention to shareholders. The “managerial - shareholder primacy” dichotomy discussions debate the degree to which shareholders can effectively express their interests given voting, control, and other issues. Principle-agent discourse addresses the mechanism that may be used to avoid divergent interests. A careful analysis of the cooperative corporation suggests that the interrelatedness of interests in a cooperative as well as the multiple capacities in which each stakeholder stands will significantly restrict divergent behavior. Mandated returns of net margins, moderated investments of equity, limited control rights, and specified patronage-based firm objectives all restrict the capacity of management to conduct the affairs of the cooperative in contravention of stakeholder interests.

If the full set of rights and obligations that can be perceived to flow among all stakeholders, the system is complex. The “nexus” in the nexus-of-contracts may not be as defined as with contracts defining a non-cooperative corporation. Most of the rights and obligations in a corporation can in fact be viewed as flowing through the organization. In a cooperative, however, this nexus is not as pronounced. The concept of “connected contracts” (Gulati Klein and Zolt) may be more applicable to the complexity of cooperative firm-stakeholder relationships, perhaps analogous to “netchains” suggested in Lazzarini Chaddad and Cook.

Separability of Rights and Obligations

Each relationship between a stakeholder and the firm and among stakeholders can be viewed as an independent, free-standing relationship giving defined rights and imposing defined obligations on only the two parties involved. In concept, each can be modified or eliminated depending on the wishes of the parties. However, the ability to separate rights and obligations is limited by a number of factors in cooperatives.

In cooperatives to a substantially greater degree than in non-cooperative corporations each element of the entire firm system directly affects all others. Economic interdependence prevents isolation of some sets of rights and obligations from others. Added to this factor is the differing complement of stakeholders. A clear example in cooperatives is the relationship between the set of stakeholders making up the patrons and those making up the equity holders. In a non-cooperative corporation the rights and obligations running between the firm and equity holders are essentially independent of the corporations’ customer interests. Equity holders lay claim to the net margins of the corporation either directly through dividends or indirectly through sale and exit from corporation participation. In a cooperative, on the other hand, rights and

obligations that cause the cooperative to distribute net margins to patrons on the basis of their participation in the cooperative's operation cannot be changed without changing the status of equity holders as possessors of rights and obligations based on residual value.

Similarly, the fact that a single entity may relate to both the firm and to other stakeholder entities in multiple capacities means that changing any one of the relationships would affect the same stakeholder because it would necessarily change the remaining status between and among the firm and stakeholders. In a more contractual formulation of the situation, the rights and obligations between stakeholders, other stakeholders and the corporation are limited to the parties to what would be an agreement if a contract actually existed. In a cooperative, the multiplicity of relationships and the interrelatedness of the impact of a change in one set of rights and obligations on others suggests that a much greater set has a direct interest in the content and performance of the implicit agreements. Elimination of the rights and obligations that require the cooperative to distribute net margins on a patronage basis rather than retain margins and corporate profit would change the essential character of all other sets of rights and obligations by changing the motivations and purposes of the cooperative organization.

The view of the firm as essentially contractual permits a description of all relationships. However, contractarians hold the position that because the relationships are contractual all principles of contract formation and enforcement also should apply. Two parties can devise a contract to suit their needs with a few specific limitations. Freedom to contract is limited only to the extent that broader policies justify such limitation. (Baarda 2001). Generally, in a market situation contracts do not need to consider the welfare of non-parties to the contract. In a cooperative, to the contrary, the very fact that the stakeholders share so many interrelated interests gives them a direct interest in all internal rights and obligations sets. This situation also holds because of the multiplicity of rights and obligations among the stakeholders.

Non-separability of rights and obligations within a cooperative firm are amenable to communitarian-progressive corporate theory positions. The various obligations of the corporation to entities identified broadly as stakeholders cannot be separated from the existence of the cooperative business. Just because the corporation exists, rights and obligations that the corporation has to various stakeholders cannot be separated from those it has to its internal stakeholders. Inseparability of rights and obligations is also suggested in views of the corporation as a team production system where the producers require coordination. The rights and obligations of stakeholders that establish essential relationships among themselves cannot be separated into parcels without destroying the whole.

The Reach of Rights and Obligations Sets

The relationship of a firm and various groups of stakeholders determines the boundary of the firm. In terms of firm theory, relationships within the firm are those that are segregated from market forces as noted previously. Decisions made within the hierarchy of the firm establish the firm's boundary. Relevant rights and obligations that bind parties will determine whether the

relationship is within the boundaries of the firm. Part of this inquiry is based on the identity of stakeholders although the reasoning can become circular if the boundaries of the firm determine whether a particular party is a stakeholder. The inquiry is continued to assess the extent to which the parties are bound by rights and obligations established by the stakeholders and the firm.

The inquiry is two-fold. First, have a sufficient collection of stakeholders been assembled and have they bound themselves by rights and obligations they have established to be a corporate body with the characteristics and protections of all corporations generally. The second part of the inquiry is to determine, assessing all sets of rights and obligations, whether the extent and character of the sets reflect the principles of not only a corporation but a cooperative corporation.

The boundaries of a cooperative corporate entity differ from those of a non-cooperative corporation. In a cooperative, the relationship that binds patrons and cooperative are not typically solely subject to market forces, although the initial sale to a marketing cooperative by a patron without a delivery contract may appear to be so. Even in that case, where the patron is a member and receives patronage refunds, the totality of the transaction is not a mere market relationship. The boundary of the firm includes entities that would not be included in the boundary of a non-cooperative corporation relative to its customers.

Sources of Rights and Obligations

The sources from which the rights and obligations of interest in this paper arise are important to determine the rules that will be applied to assess whether rights are being realized and obligations are being met. Formal sources include corporate law, including cooperative statutes, the charter, and the bylaws. A second source is specific agreements between cooperative and patron, some of which may contain essential provisions about operating on a cooperative basis. Finally, the corporate entity may establish policies and practices that are binding on itself for some purposes.

The legal foundations for rights and obligation will vary. Some will be established by the incorporation statute. These typically are the basis for creating a corporate entity with the protections and obligations of a corporation. The rights and obligations established with the act of incorporation are usually supplemented by corporate documents such as the articles of incorporate and a set of bylaws to govern the internal relationships of the corporation. For a cooperative, a different set of rights and obligations will be established, part of which qualify the firm as a corporation and part of which establish the collection of relationships that qualify it as a cooperative for purposes of the statutory structure. These may be, and always are, modified and clarified by supplemental documentation in the articles of incorporation and the bylaws. In addition, marketing agreements, membership agreements, cooperative policy statements and other documents describe relationships in more detail.

The major dichotomy between contract and corporate law views of the corporation are exemplified by the source issue. A contract view would place the source solely in the hands of

individual stakeholders. The non-contractarian view would point to corporate law mandates as the primary source of authority. The source of authority has implications for how relationship can be “enforced” and how much flexibility individual participants have to tailor the relationships to their specific purposes. A more communitarian approach may suggest that society authorizes corporate existence while imposing certain obligations to the community in exchange.

Protecting Interests

The goal, indeed the sole overarching goal, of a firm is to establish an economic-legal method that will further the economic interests of participating parties. This principle provides the justification for formally recognizing the rights of individuals to establish relationships with each other and with society. More fundamentally, this is the justification for a social system that will enforce rights and obligations privately created for private purposes. (Baarda 2002 notes these issues in the contracting context). Two processes are implied by this analysis. First, individuals articulate their interests and create sets of rights and obligations that they believe will further their own objectives. This is the fundamental act of contracting, recognizing property interests, and creating firms, including corporations. This issue will be noted further in the section on mandated objectives. The second step is to find ways to protect the interests so created where either the rights and obligations are not met by all parties or where the rights and obligations actually established end up not promoting the expected interests as originally conceived.

Stakeholder identity and the full complement of rights and obligations by their nature define interests to be protected. For corporations, cooperative or non-cooperative, a significant mechanism for interest protection is found in the duties imposed on boards and management. Interests are not protected when boards or management fail to meet these obligations, and the mechanism for protection is action against the offending parties. The first line of defense is established in corporate rights and obligations sets that permit those who control the corporation to remove the offending parties – board members through stockholder action, management by board action. The second line of interest protection is legal action against the offending parties either by private litigation or by actions of society through regulators and enforcement agencies with necessary authority.

Both of these mechanisms are available for cooperative corporations, but their application is more complicated in some ways, less complicated in others. Actions against the board of directors for failing to protect stakeholder interest is common in the form of director replacement, a seemingly common process in cooperatives because of more direct interests in the affairs of the cooperative by the stakeholders who have power of removal. Legal action is less common and has more similarities with such actions in the case of non-cooperative corporations. It is a more complicated process in cooperatives because of the multiplicity of interests and stakeholders captured in the rights and obligations sets established to implement varied interests.

Protection of interests under contractarians' legal theories seem to suggest that because the corporation is a nexus-of-contract, violations of rights and obligations so established would be corrected by actions similar to breach of contract actions. Following this reasoning, the actions would be private only and would result in only remedies available in contract action. This seems too restrictive, particularly for cooperatives with the greater complement of rights and obligations sets applicable to stakeholders standing in multiple capacities in the cooperative firm. Anti-contractarians may point to the corporate law (including cooperative statutory law) that gives rights not only to individual stakeholders but to society as a whole to protect certain interests. In a somewhat in-between position, cooperative statutes often describe relationships that stakeholders can enforce or at least use in their efforts to protect interests.

Economic environs theory reflects the sets of rights and obligations used to establish and protect interests, drawing on historical lessons about behavior and on assessments of what rights and obligations will best protect relevant interests. The mechanisms for enforcement are generally based on long precedence and experience. Communitarian-progressive corporate theory would assign a broader set of stakeholders with rights to take some specific action to protect their interests. The mechanism for this is generally the assignment of obligations on the part of the firm to recognize interests, and allow wronged stakeholders to take action necessary under the methods of enforcement generally available to stakeholders such as exerting internal control, bringing individual actions at law, or obtaining the assistance of society through enforcement agency actions.

Authority and Flexibility to Establish Rights and Obligations Sets

Authority for individuals to create rights and obligations in relation to others that can be enforced on their behalf are recognized in most societies to some degree and have been greatly refined in Western societies primarily in the context of a certain view of economics and individualism. As noted previously, individuals are given the right to create contractual rights and obligations among themselves in their own interests and society will enforce the agreements so made with exceptions. (Baarda 2002). Private ownership of property with all of the powers associated with ownership is also recognized. In the case of corporate firms, enabling laws establish the right to create corporations and assigns to the firms certain critical characteristics associated with an individual. The corporation is a legal person. This applies as will to cooperative corporations.

Theoretical constructs of the corporation assign differing sources of authority to create the rights and obligations that form a corporate entity. Similarly, they address flexibility to formulate individualized rights and obligations sets. The contractarian view of corporations views rights and obligations sets as contractual in nature. The authority to create binding agreements is founded on rights to make enforceable contracts. A corollary to that theory gives exceptional flexibility to stakeholders to establish the rights and obligations they wish.

Anticontractarians disagree. A major point of contention between the two is that anticontractarians believe that corporation statutes establish sets of rights and obligations that cannot be changed by private contract among stakeholders. Contractarians, on the other hand, view corporate statutes as default statutes, establishing rights and obligations sets unless changed by stakeholders.

This dichotomy between the nexus-of-contracts theory and the position of the anticontractarians is in some ways at the heart of current discussions of cooperative principles and the nature of the cooperative corporation. Accepting cooperative principles as an essential concept of cooperative corporations, the cooperative incorporation statutes can be viewed as the embodiment of accepted principles. Cooperative stakeholders are not free to contravene such principles by individual agreements as would be natural under contract principles.

Two difficulties accompany a complete statutory authority theory for cooperatives. First, careful reading of the statutes shows a great deal of leeway in what rights and obligations sets are actually mandated. (See Reis for early criticism of the most common type of statutes). New statutes are being enacted that deviate substantially from previously accepted cooperative principles.¹³ The conflicts raised by new statutory constructs are reflected in criticism that they

¹³ CHAPTER 105-H.F.No. 984; An act relating to cooperatives; authorizing businesses to organize as cooperative associations; providing penalties; amending Minnesota Statutes 2002, sections 80A.14, subdivision 17; 80A.15, subdivision 2; 322B.70, subdivision 1; proposing coding for new law in Minnesota Statutes, chapter 322B; proposing coding for new law as Minnesota Statutes, chapter 308B.

have abandoned cooperative principles as normally understood and applied. Many cautions have been raised about their use by organizations.¹⁴ The former Deputy Administrator for USDA's Rural Business-Cooperative Service stated:

Cooperative leaders need to stop for a moment and ask themselves: "Is a law that permits this much deviation from the cooperative norms of user-ownership and user-control coupled with a provision that only 15 percent of earnings must be returned to users based on patronage really a law authorizing the formation of cooperatives?" If someone can answer this question "yes," a second question needs to be addressed: "Just what, if anything, does the term cooperative mean?"

When an organization calls itself a "cooperative," it has an obligation to meet expectations that it will act like one. Delaware could amend its laws to create another statute that lets General Motors or any other large investor owned firm to call itself a "cooperative." But if such entities disregard the key cooperative characteristics of user ownership and control and benefits flowing to the users based on patronage, the integrity of all cooperatives is called into question.¹⁵

The second difficulty is that cooperatives may take many different forms and private arrangements such as membership agreements, marketing agreements, and tailored bylaws may insert considerable variation into a cooperative corporate structure. The difficulty with a contractarian view is that corporations cannot be called cooperative under all circumstances, and the flexibility to create acceptable sets of rights and obligations is limited. The authority and flexibility of stakeholders to design and create sets of rights and obligations to serve their private interests in a cooperative is substantial but not unlimited. The balancing problem is a reflection of the continuum character of corporate structure between cooperatives and non-cooperative corporations. While an institutional approach would give weight, properly so, to the cooperative tradition, a communitarian approach may suggest an even broader scope of cooperative identity.

Mandated Objectives

The final characteristic of the rights and obligations analysis describing and defining cooperative and non-cooperative corporations addresses objectives. Firms are created for a purpose. The firm itself has an objective that may or may not be formalized in an objective function. Further, individual stakeholders each have an objective. The individual stakeholder objectives are bound together in a firm by sets of rights and obligations that presumably match the purposes of the corporate body with the collective objectives of the stakeholders. Conflicts among interests are at the center of most corporate legal and economic theory, as well as corporate law in practice.

¹⁴ For example, Frederick, discussing the Wyoming statute.

¹⁵ Torgerson 2002.

As previously discussed, separation of ownership and control suggested fundamental conflicts in the firm such as principal and agent issues. Efforts to address agency costs and align interest of all stakeholders to achieve firm objectives (profit maximizing in one formulation, firm wealth creation in another, and maximizing value to shareholders in another, among many others) have led to significant advances in firm theory. Corporation as legal entity, separation of ownership and control, and the firm as transactions regulated by rights and obligations sets are part of the overall process of defining and achieving objectives.

In the last two decades, shareholder value has become the central legally-mandated objective of corporate firms although the general law and economics view of corporations has long held that position. Simply stated, “[t]he objective in corporate finance is stated, most broadly, as the maximization of firm value and, more narrowly, as the maximization of the stock price.” (Damodaran, p. 117). Needless to say, such a position has not gone unchallenged in either economic or legal discourse.

Cooperative – non-cooperative distinctions are sharp in both objectives and stakeholder interests as defined by cooperative principles. Objectives in both cooperative and non-cooperative corporations are based on alignment of individual motivations, firm objectives, and obligations of the firm to meet mandated objectives, all determined by cooperative principles. The cooperative mix of rights and obligations to achieve objectives is distinct, but it is defined. The mechanism to implement cooperative principles relies on rights and obligations sets making up a cooperative.

For future consideration, mandated objectives, their relation to the nexus-of-contracts view of corporations, those who do not accept the full-blown contracts theory of corporations, and progressive views of corporations will be important considerations.

Conclusion

The discussion of cooperative – non-cooperative corporation issues is formulated in terms of the sets of rights and obligations within any firm that define its characteristics. The juncture of law and economics, in particular that related to firm theory, was noted in very summary fashion and was applied to illuminate cooperative issues. The combination of the “rights and obligations” analysis with cooperative and general corporation principles provides another means by which to define and investigate fundamental changes in cooperatives.

The paper is a summary of concepts. Further research will select the topics most likely to clarify issues and, most importantly, offer guides as cooperatives change, laws change, and cooperative economics change.

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